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IN THE

Supreme Court of the United States

OCTOBER TERM, 1956

No. 737....

HARRY M. STEVENS, INC.,

Petitioner,

vs.

JAMES W. JOHNSON, Former Collector of Internal Revenue for the Third District of New York.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

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HARRY M. STEVENS, INC.,

Petitioner,

vs.

JAMES W. JOHNSON, Former Collector of Internal Revenue for the Third District of New York.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judment of the United States Court of Appeals for the Second Circuit in the above cause.

Opinions Below

The opinion of the District Court (R. 29a-33a), holding petitioner is entitled to a tax refund of $266,016 plus interest, is reported at 115 F. Supp. 310, while the opinion of the Court of Appeals (R. 42a), which reversed the District Court, is reported at 238 F. 2d 436. Both opinions are set forth in Appendix A to this Petition.

Jurisdiction

The judgment of the Court of Appeals, reversing the judgment of the District Court, was entered November 9, 1956 (R. 49a). Jurisdiction of this Court is invoked under 28 U.S.C. § 1254. This Petition is filed within the time prescribed by 28 U.S.C. § 2101(c).

Questions Presented

Section 102 of the 1939 Internal Revenue Code levies a penalty surtax upon the undistributed income of those corporations which improperly accumulate surplus. Petitioner is a corporation which, for the year 1946, comes within the section 102 penalty surtax provisions. The issue in this refund suit relates to how such a penalty surtax should be computed.

The penalty surtax is levied on what is referred to as "section 102 net income," which is ordinary net income adjusted by subtracting therefrom certain items that clearly are not improper accumulations. Section 102(d)(1) accordingly provides for subtracting from net income the federal income taxes "paid or accrued during the taxable year." Petitioner is on the cash basis. The federal income taxes paid by petitioner during 1946, which were accrued during 1945 on 1945 income, are far less in amount than the taxes actually accrued by petitioner during 1946 on 1946 income and paid later. Thus the Government would gain from an interpretation of the statute requiring that petitioner, as a cash-basis taxpayer, should compute the penalty surtax by subtracting only the smaller amount of prior-year tax paid during 1946, rather than the larger amount of tax accrued during 1946 and paid later. The Government contended for this interpretation even though it seems clear that a taxpayer must reserve enough funds to pay the taxes due on the income earned in a particular

year and to such extent could not be considered to violate any policy against accumulating funds improperly. The District Court rejected the Government's interpretation and awarded petitioner a refund, relying primarily on an unbroken line of cases (*Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (D. C. Cir. 1945) cert. denied 325 U. S. 881 (1945) and others) which had arisen under the comparable penalty surtax provisions of the personal holding company sections of the Code, and which had held that in computing such penalty the taxpayer was entitled to subtract the amount of federal income taxes which had actually accrued during the particular tax year even though the taxpayer was on a cash basis. Thereafter *United States* v. *Olympic Radio & Television, Inc.*, 349 U. S. 232 (1955) and *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237 (1955) were argued before this Court. *Olympic* and *Lewyt* involved a question arising under other sections of the Code containing superficially similar language; however, they required a computation to be made not for any type of penalty tax but rather for the purpose of affording the taxpayer the benefit of the net operating loss carryback deduction in the determination of "net income." The Government's briefs in this Court urged that, in connection with such carryback benefits, the tax item in the computation must always be included on the same basis—whether cash or accrual—as the taxpayer had used in maintaining his books for that year. As one of the primary points in its *Olympic* and *Lewyt* briefs, the Government represented to this Court that the *Clarion* line of personal holding company cases—and likewise the District Court's very decision in petitioner's favor in the present case—were "clearly distinguishable" because they arose under the separate penalty provisions of the statute. Having obtained favorable decisions in *Olympic* and *Lewyt*, the Government then turned around, and despite the representations it had previously made to this Court for the purpose of persuading this Court in those cases, nevertheless sought in the

present case to obtain a reversal of the District Court's judgment by placing great reliance on this Court's *Olympic* and *Lewyt* decisions. The Court of Appeals, in reversing, accepted the *Olympic* and *Lewyt* decisions of this Court as controlling, saying that otherwise "we well might have affirmed on [the] lucid opinion below."

In these exceptional circumstances the questions presented are whether the computation provisions of the section 102 penalty surtax have been incorrectly construed; whether the *Olympic* and *Lewyt* decisions of this Court have been misapplied; and whether the Government should be allowed, by in effect repudiating the representations it made in its *Olympic* and *Lewyt* briefs submitted to this Court, to deprive petitioner of the $266,016 (plus interest) refund to which the District Court held petitioner entitled.

Statutes Involved

The statutes involved in this case are the following Sections 102, 43, 48(c), 500, 504, 505 and 507(a) of the Internal Revenue Code of 1939. Their text is set forth in Appendix C to this Petition.

Statement of the Case

The facts are not in dispute.

The Commissioner of Internal Revenue assessed a deficiency of $565,070, plus interest, against petitioner for section 102 penalty surtax for the year 1946. The section 102 surtax is a penalty surtax imposed, in addition to the ordinary taxes upon income, against corporations which improperly accumulate surplus. The penalty surtax is levied upon the undistributed "section 102 net income", such section 102 net income being defined by section 102(d)(1) of the Internal Revenue Code of 1939 as the

ordinary net income minus the sum of certain specified items. Among the items to be subtracted from ordinary net income, for the purpose of computing the penalty surtax, are the income and excess profits taxes "paid or accrued during the taxable year."

The taxes on petitioner's 1946 income—the year for which the Commissioner assessed the undistributed surplus penalty tax—were $726,036 while those for 1945 but paid in 1946 were $142,660.

Petitioner reports its income on the cash basis. The Commissioner, because of this, took the position that, in computing the section 102 penalty surtax on 1946 income, the taxes necessarily accrued during 1946 for payment early the next year on 1946 income could not be deducted, but that, instead, petitioner could deduct only the much smaller tax on 1945 income.

Petitioner paid the assessed penalty surtax (with interest) in 1950 and thereafter filed its claim for refund, which was rejected. The suit for refund was then instituted in the United State District Court for the Southern District of New York.[1] Count II of petitioner's complaint asked for a recovery of $266,061 (plus interest), which is the amount by which the section 102 penalty surtax would have been reduced if the 1946 income tax, rather than the 1945 income tax, had been subtracted in computing the section 102 penalty surtax for 1946 (R. 4a-5a).

Both parties moved for summary judgment as to Count II. The District Judge decided in favor of petitioner in

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[1] A suit for refund is properly brought and continued against the collector in office at the time the tax was paid even where, as here, the collector has ceased to hold office. *Smietanka* v. *Indiana Steel Co.*, 257 U. S. 1 (1921); *United States* v. *Kales*, 314 U. S. 186, 197-200 (1941); *Popham* v. *Jamison*, 80 F. Supp. 221 (W. D. Mo. 1948); Rev. Rul. 139, 1952-2 Cum. Bull. 470.

an opinion filed September 21, 1953 (R. 29a-33a; see Appendix A to this Petition). The opinion rejected the Government's interpretation of the statute and held instead that petitioner could properly subtract the income taxes accrued during 1946 in computing the section 102 penalty surtax for 1946. In so holding, the District Court relied on a line of cases, beginning with *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (D. C. Cir. 1945), cert. denied, 325 U. S. 881 (1945), which had been decided under the parallel penalty surtax provisions of the personal holding company provisions of the 1939 Code. Judgment for petitioner was entered November 18, 1953 (R. 34a-35a).[2]

Notice of appeal to the Court of Appeals for the Second Circuit was filed by the Government in 1953 (R. 40a-41a), but the argument on such appeal was not heard by the Court of Appeals until 1956. In the intervening period, there were presented to this Court the cases of *United States* v. *Olympic Radio & Television*, 349 U. S. 232 (1955), and *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237 (1955). Those cases both involved taxpayers on the accrual basis attempting to take advantage of the benefits permitted under section 122 of the Internal Revenue Code of 1939 relating to carryback of net operating losses in the computation of "net income." The taxpayers in both *Olympic* and *Lewyt*, and the lower court in *Olympic*, cited as authority the line of decisions commencing with *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (D. C. Cir. 1948), cert denied, 325 U. S. 881 (1945), involving the imposition of a penalty surtax upon the undistributed income of personal holding companies. The Government, in seeking to persuade this Court that such authorities were

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[2] The District Court's judgment also dismissed Count I of the complaint, pursuant to stipulation of the parties, and dismissed Count III of the Complaint (R. 34a-35a). Petitioner filed a notice of cross-appeal from the dismissal of Count III (R. 38a-39a) but such cross-appeal was later withdrawn. Accordingly, only Count II remained for decision by the Court of Appeals.

wholly inapplicable to the problem actually raised by *Olympic* and *Lewyt*, argued at some length that the penalty surtax situations were different. Indeed, the Government briefs in this Court did not only distinguish the personal holding company cases upon the ground that they were applicable only to the computation of penalty surtaxes; the Government likewise represented that the opinion of the District Court in petitioner's favor in the instant case, "involving surtax under Section 102 on corporations improperly accumulating surplus, is distinguishable on like grounds." Because the Government briefs make this distinction so effectively, and hence help to show how great an injustice has been inflicted upon petitioner by virtue of the decision of the Court of Appeals, the pertinent portions of the Government's *Olympic* and *Lewyt* briefs as filed in this Court are set forth in Appendix D to this Petition.

Contrary to the position it had just taken in this Court, the Government then sought in the present case to obtain a reversal of the District Court's judgment by arguing that the instant case is governed by this Court's *Olympic* and *Lewyt* decisions. On November 9, 1956, the Court of Appeals did reverse the District Court, taking the view that this case was now controlled by the Supreme Court's decisions in *Olympic* and *Lewyt* (R. 49a; see also Appendix B to this Petition). The opinion of the Court of Appeals states in part:

> "If the decisional law were now in the state existing when the case was submitted to Judge McGohey, we well might have affirmed on his lucid opinion below. However, in the intervening time the Supreme Court has announced its decisions in *United States* v. *Olympic Radio & Television*, 349 U. S. 232 and *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237 * * * Under the constraint of these cases, we must reject the plaintiff's contentions in the case now before us."

Reasons for Granting the Writ

This is not just another routine tax case.

On the contrary, it presents issues of fundamental importance with respect to the standards which should control the Government's conduct of tax litigation in this Court and in the lower federal courts. An exercise of this Court's supervisory jurisdiction is called for, to assure that the principles of justice shall be no less binding upon the Government in its dealings with the taxpayer than they are binding upon the taxpayer in his dealings with the Government.

By reversing the District Court under the supposed compulsion of this Court's decisions in *United States* v. *Olympic Radio & Television*, 349 U. S. 232 (1955), and *Lewyt Corp.* v. *United States*, 349 U. S. 237 (1955), the Court of Appeals has subjected petitioner to an additional penalty surtax and thus deprived petitioner of a substantial tax refund for which the District Court had granted judgment. If the Court of Appeals decision were to stand, it would allow the Government to benefit from the Government's unsupportable repudiation of the express representations which the Government made to this Court in the *Olympic* and *Lewyt* cases. Such a result would be especially unconscionable in view of the firmness and vigor of the Government's disclaimers, in its briefs submitted to this Court in *Olympic* and *Lewyt*, to the effect that no similarity existed between the "net income" carryback situations there involved and the penalty surtax situations including the one we have here.

Particularly in the light of the representations made by the Government to this Court in *Olympic* and *Lewyt*, it is plain that the Court of Appeals here has gravely misinterpreted and misapplied the *Olympic* and *Lewyt* decisions. The compulsion which the Court of Appeals found in those decisions is a compulsion which simply does not exist.

By such misinterpretation and misapplication of the *Olympic* and *Lewyt* decisions the Court of Appeals has, in addition, created a conflict with the decisions of two other circuits involving an almost identical question under the parallel penalty surtax provisions of the personal holding company sections of the 1939 Code. *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (D. C. Cir. 1945), cert. denied, 325 U. S. 881 (1945); *Birmingham* v. *Loetscher Corp.*, 188 F. 2d 78 (8th Cir. 1951).[3] As appears from the opinion of the District Court in the present case, as well as from the Government's briefs in this Court in *Olympic* and *Lewyt*, the personal holding company penalty surtax and the section 102 penalty surtax on accumulations are *in pari materia;* they have a common purpose and origin. Nor can a distinction arise by virtue of the fact that the personal holding company sections are physically placed in Chapter 2 of the 1939 Code, whereas the section 102 penalty surtax is physically placed in Chapter 1 of the 1939 Code. It is true that Chapter 1 also contains in section 48(c) the definition of "paid or accrued" to which this Court adverted in its *Olympic* and *Lewyt* opinions. But the personal holding company sections authorize, in section 505 (a)(1), exactly the same subtraction for taxes "paid or accrued" as is set forth in section 102; and the personal holding company sections further provide, in section 507 (a), that "The terms used in this subchapter shall have the same meaning as when used in Chapter 1". Accordingly, the personal holding company penalty surtax is in exactly the same relationship, if any, to the definition in section 48(c), on which the Court of Appeals here placed some reliance, as is the section 102 penalty surtax. This makes it clear that the *Clarion* line of decisions is not distinguishable from the present case, and the Govern-

[3] There were also two decisions of the Second Circuit, *Joan Carol Corporation* v. *Commissioner*, 180 F. 2d 751 (2nd Cir. 1950) and *Aramo-Stiftung* v. *Commissioner*, 172 F. 2d 896 (2nd Cir. 1949), which were in full accord with *Clarion*.

ment was plainly correct when it treated them as equivalent in the briefs it submitted in *Olympic* and *Lewyt*. The language of section 48(c) has no more relevance to the decision of the present case than it did to the decision of the *Clarion* line of cases.[4]

It is evident that no question relating to the computation of penalty surtaxes was ever before this Court in *Olympic* and *Lewyt*. Not only is this apparent from the face of this Court's opinions in the two cases; it is underscored by the elaborate presentation of the subject matter in the briefs which the Government submitted to this Court. As already noted, we have set forth the pertinent excerpts from those briefs in Appendix D to this Petition; accordingly, they will only be summarized here. For example, in the *Olympic* case, it will be recalled, the Court of Claims had held in favor of the taxpayer, 108 F. Supp. 109 (1952), placing principal reliance upon *Clarion* and related cases. Such cases and others of similar purport, also involving penalty

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[4] In its opinion in *Clarion* the Court of Appeals for the District of Columbia expressly discussed the definition of "paid or accrued" in section 48(c), and showed its complete irrelevance to the penalty surtax situation, as follows [148 F. 2d at 675-676, footnotes omitted]:

> The statutory definition of the words, found in Title I of the Act [citing § 48(c) in a footnote], and on which the Tax Court presumably relied, declares that "the terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the *net income* is computed under this Part." [Italics supplied.] But, obviously, this definition was intended to apply to the method of computing *net income*, and has no reference or relevancy to the subject matter of what, for the purposes of the newly added provision in relation to personal holding companies, is taxable as *undistributed* income. In other words, having determined "net income" in accordance with the accounting methods of the taxpayer, there is no need to consider whether an ordinary income tax was "paid" or whether it was "accrued", since in either event it was a deductible item and no longer represented *accumulations* of income, which it was the intent of this tax to force out of the "incorporated pocketbook" and into the hands of individual taxpayers.

surtax under the personal holding company sections of the Code, as well as the District Court's decision in favor of petitioner in the present case, were thereafter cited to this Court by the taxpayers in both *Olympic* and *Lewyt*.[5] The Government's briefs in this Court squarely met these contentions by arguing in detail that the line of personal holding company cases cited was "clearly distinguishable" on the ground that such cases arose under the penalty surtax provisions of the statute; and it is especially important to note that in this connection the Government also explicitly represented to this Court that the decision of the District Court in favor of the present petitioner, involving surtax under section 102 on corporations improperly accumulating surplus, "is distinguishable on like grounds."[6]

The Government was entirely correct when it represented to this Court that clear differences existed between the *Olympic* and *Lewyt* "net income" situations, on the one hand, and the penalty surtax situations on the other.[7] The carryback benefit in the computation of "net income" in *Olympic* and *Lewyt* was in no sense a penalty—such as we have here—but was rather "a deduction which one obtains not as a right, but as of grace" (349 U. S. at 235). Moreover, the basic thrust of the statutory policies was entirely different. On the merits it would seem almost inconceivable that a Congressional policy directed against improper corporate accumulations could ever have been intended to inflict a penalty surtax on the reserve being accumulated, in

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[5] See the taxpayer's brief filed in this Court in *Olympic*, at pages 8-10, 14, 19, 24-25, 29-31; and the taxpayer's brief filed in this Court in *Lewyt*, at pages 8, 20-29.

[6] See especially the Government's brief in *Olympic*, at pages 16-17 (reproduced in Appendix D to this Petition).

[7] The marked difference between the two situations has also been recognized by the Treasury Department in its regulations (see Treas. Reg. 118, § 39.505-1(f), as added by T. D. 6079, approved July 8, 1954, 1954-2 Cum. Bull. 276) and by other official action (see Commissioner's acquiescence in *Wm. J. Lemp Brewing Company*, 18 T. C. 586 (1952), acq. 1952-2 Cum. Bull. 2).

an orderly business way, for paying in the following year the large income tax obligation which was accruing during the particular year's operations.[8] Indeed, the accumulation of such a reserve, far from being improper from any business or public policy standpoint, may be the only means of protecting the Treasury by assuring that the taxes which are being accrued can actually be paid when payment becomes due.

Nothing in the historical materials bearing on the interpretation of the statute compels or even suggests the far-fetched and inequitable result which the Court of Appeals felt constrained to adopt in the present case. All the prior judicial interpretations give full support to the decision of the District Court in petitioner's favor. The formal submissions which the Government made to this Court in *Olympic* and *Lewyt* provide an irrefutable showing that *Olympic* and *Lewyt* did not put into issue these prior judicial interpretations of the separate penalty surtax provisions. Having thus strongly represented to this Court that the prior decisions referred to—including the District Court decision in petitioner's favor in this very case—were based upon the entirely different penalty surtax concept, the Government can hardly be permitted now to deprive petitioner of the tax refund on the theory that the two concepts are really the same.

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[8] This was clearly recognized in the Government's brief in the *Lewyt* case at page 20 (reproduced in Appendix D to this Petition), where the Government, in representing to this Court that such a distinction existed, said that "the distinction is summarized in Judge Madden's dissenting opinion [in the Court of Claims] in the *Olympic* case", as follows:

> "To penalize a corporation for not distributing as dividends money which it either does not have, because it pays it out in back taxes during the year, or which prudence would require it to keep, because it will be needed to pay taxes accrued during the year though not payable until the following year, would seem to amount to penalizing sound management. The instant situation presents no comparable pressure of equity against the text of the statutes."

In persuading the Court of Appeals to treat *Olympic* and *Lewyt* as applicable to the present case, the Government has indulged in turnabout tactics which should not be given the sanction of the courts. Compare *Rosenman* v. *United States*, 323 U. S. 658, 663 (1945); *Federal Communications Commission* v. *American Broadcasting Co.*, 347 U. S. 284, 296 (1954). Such an extraordinary manner of conducting litigation can hardly be deemed consistent—to borrow a phrase from one of this Court's most recent decisions—with "the dignity of the United States". *Mesarosh* v. *United States*, 352 U. S. 1, 9 (1956).

Conclusion

More than thirty-five years ago this Court, speaking through Mr. Justice Holmes, said: "Men must turn square corners when they deal with the Government". *Rock Island, etc. R.R.* v. *United States*, 254 U. S. 141, 143 (1920). This surely is a principle which works both ways; the Government has a reciprocal obligation to turn square corners when dealing with its citizens. It is a serious imposition both upon the courts and upon the taxpayer for the Government to engage in the course of conduct which this litigation discloses. This is particularly true where, as a matter of sound tax policy in the light of the Congressional objectives, it is so clear that the taxpayer is entitled to retain the judgment which the District Court entered in its favor.

As we have shown, the Government's express representations to this Court in *Olympic* and *Lewyt* point definitively to a result exactly the opposite of the decision which the Government has now obtained from the Court of Appeals in this case. Particularly in view of the fact that it was at the bar of this Court that the Government made such representations, it is in the public interest that this Court should now grant a writ of certiorari in order to set the matter straight, to correct the manifest error of the

Court of Appeals, to eliminate the conflict of circuits which has so needlessly been created, and to give prompt and effective discouragement to the use of such litigation tactics by the Government whether in tax cases or in other types of cases.

Furthermore, if the Court grants a writ of certiorari, and if the Court considers that the merits of the question have already been sufficiently presented to it by virtue of the extensive treatment recently afforded by the briefs submitted in *Olympic* and *Lewyt,* then it is respectfully suggested that the Court may also wish to consider whether a summary reversal, with reinstatement of the District Court's judgment, would be in order. Compare *Montana ex rel. Johnson* v. *State Board of Land Commissioners et al.,* 348 U. S. 961 (1955).

Respectfully submitted,

JOSEPH WALKER,
Counsel for Petitioner.

Appendix A

Opinion of McGohey, *D. J.*, on Reargument of Motions for Summary Judgment

(28)

IN THE

UNITED STATES DISTRICT COURT,

FOR THE SOUTHERN DISTRICT OF NEW YORK.

CIVIL ACTION No. 70-138

HARRY M. STEVENS, INC.,

Plaintiff,

v.

JAMES W. JOHNSON, Former Collector of Internal Revenue for the Third District of New York,

Defendant.

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McGOHEY, D. J.

Opinion of McGohey, D. J., on Reargument of Motions for Summary Judgment

Both parties move for summary judgment on the (29) complaint as amended,[1] which seeks recovery, with interest, of $266,061.41 alleged to have been erroneously and unlawfully assessed and collected as taxes due for the year 1946 pursuant to Sec. 102 of the Internal Revenue Code.[2]

The facts are not in dispute. Plaintiff is a New York corporation. It keeps its books of account and files its tax returns on the basis of cash receipts and disbursements. Its ordinary income tax on 1945 income amounted to $142,660.64 and was paid in 1946. Its ordinary income tax on 1946 income amounted to $726,036.46, part of which was paid in 1947 and the balance in 1949.

In 1949, the Commissioner of Internal Revenue assessed a deficiency of $565,070.70 in the tax imposed by Sec. 102. The plaintiff having paid the amount assessed plus interest of $104,313.59, duly filed with the defendant a claim, which has not been acted on, for refund of $266,061.41, the total of the alleged overassessment plus the interest paid thereon.

(30) Sec. 102 imposes on business corporations "improperly accumulating surplus," a surtax the amount of which is determined by applying the several prescribed rates respectively to specified portions "of the *undistributed* section 102 net income [emphasis supplied]. "Section 102 net income" is defined so far as here relevant as "the net income . . . minus the sum of . . .

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[1] The original complaint contained 3 "counts." On previous motions count 3 was dismissed with leave to amend and summary judgment sought by both parties on count 2 was denied because the pleadings as they then stood raised an issue of fact as to whether the plaintiff was liable to any tax under § 102. The plaintiff has not amended count 3. It has stipulated to a dismissal of count 1 with prejudice and amended count 2, to eliminate the issue of fact.

[2] 26 USCA 102.

Federal income . . . taxes . . . paid or accrued during the taxable year . . .'"[3]

In computing the amount of the plaintiff's "section 102 net income" for 1946, the Commissioner deducted from its "net income" the income tax of $142,660.64 paid in 1946 on 1945 income. The plaintiff contends that the Commissioner should have deducted instead, the income tax of $726,036.46 which "accrued" in 1946 on that year's income. The defendant replies that since the plaintiff's accounts are kept on a cash basis, deduction of taxes "accrued" in 1946 is prohibited by Sec. 43 of the Code.[4] That section provides that "The deductions and credits . . . provided for in [chapter 1 of which Sec. 102 is a part] shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, (31) unless in order to clearly reflect the income the deductions or credits should be taken as of a different period."

I think the defendant's view of the law is incorrect. In order to compute the tax here involved, the taxpayer's "net income" must first be determined according to the taxpayer's basis of accounting i. e., whether "cash" or "accrual." But then, taikng the "net income" thus arrived at as a base figure, it is also necessary to compute and "clearly reflect" the *undistributed* Sec. 102 net income to which the rates are to be applied. And in order to do that for any year, it seems to me to be necessary, regardless of the taxpayer's basis of accounting, to deduct from that year's "net income" the amount of "Federal income tax . . . accrued" on that year's "net income."[5] The amount of this "accrued" tax, it is true, re-

[3] 26 USCA § 102(d)(1)(A).

[4] 26 USCA 43.

[5] See *Aluminum Castings Co.* v. *Collector*, 282 U. S. 92, 98; *Rodney* v. *Hoey*, 53 F. Supp. 604, 608.

mains at year's end in the taxpayer's possession undistributed. But surely it is not for that reason "improperly accumulat[ed] surplus" or "undistributed section 102 net income" in the statutory sense, since it can neither be retained as surplus nor distributed as dividends but must be paid over to the Government in the succeeding year.

The precise point involved here seems not to have been judicially decided. But the Courts of Appeal for the (32) District of Columbia[6] and for the Second[7] and Eighth[8] Circuits have held that personal holding companies, though on a cash basis, should be allowed, under Sec. 505(a)(1) which is similar to Sec. 102(d)(1)(A), to deduct taxes "accrued" in the current year in computing their surtax under Sec. 500 of the Code. That tax which is imposed on improper accumulations of income by personal holding companies, is held to apply "solely to the income transactions of a single year." I think it clear that the Sec. 102 tax must be held to apply in the same way. Its obvious purpose is to force improper accumulations of *each year's income* out of the "incorporated pocketbook[s]" of business corporations and into the hands of stockholders where they will be taxable, by the imposition of a penalty tax on the amounts so accumulated. That too is the purpose of Sec. 500 as appears from the Committee reports[9] recommending enactment of the sections relating to personal holding companies.[10]

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[6] *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671, Cert. denied 325 U. S. 881.

[7] *Aramo-Stiftung* v. *Commissioner*, 2 C. 172 F. 2d 896; *Joan-Carol* v. *Commissioner*, 2 C. 180 F. 2d 751.

[8] *Birmingham* v. *Loetscher Corp.*, 8 C. 188 F. 2d 78.

[9] Ways and Means Committee—HR R. No. 704, 73d Cong. 2d Sess. § (4).

[10] 26 USCA §§ 500 ff.

Indeed, prior to 1934, Sec. 102 applied to the latter as well as to ordinary business corporations. In the Internal Revenue Act of 1934, Congress removed personal (33) holding companies from the operation of Sec. 102 but only in order more effectively to reach their improper accumulations. There is nothing in the Report, however, or in the Code, to suggest that the legislative purpose to penalize improper accumulations of corporate income was modified in favor of personal holding companies. Neither is there anything to suggest that they were intended to be preferred in the matter of deducting "paid or accrued" taxes in computing the amount to be subjected to the penalty tax. Rationally, therefore, the words which authorized deduction of taxes "paid or accrued" should not be given in Sec. 102(d)(1)(A) a meaning different from that which the Courts have given to the same words in Sec. 505(a)(1). The example used by Chief Judge Groner in the *Clarion Oil* case is appropriate here. If the plaintiff's undistributed section 102 net income for 1946 had amounted to no more than $726,036.46, the sum needed to pay the plaintiff's ordinary income tax on 1946 "net income", "the Commissioner never in the world would have contended that it should also pay the penalty tax on the sum so reserved, for that sum was not [undistributed Sec. 102 net income] in the statutory sense, but for all practical purposes was 'earmarked' for payment of accrued taxes not then payable."

The plaintiff's motion for summary judgment on the complaint as amended is granted. The defendant's motion is (34) denied.

Settle order.

Dated: New York, N. Y., September 21, 1953.

JOHN F. X. McGOHEY
U.S.D.J.

Appendix B

Opinion of *Hincks, C. J.*, on Appeal

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 15—October Term, 1956.

(Argued October 2, 1956 Decided November 9, 1956.)

Docket No. 24052

HARRY M. STEVENS, INC.,

Plaintiff-Appellee,

vs.

JAMES W. JOHNSON, Former Collector of Internal Revenue for the Third District of New York,

Defendant-Appellant.

Before:

FRANK, MEDINA and HINCKS,

Circuit Judges.

Appeal from a judgment of the District Court for the Southern District of New York, John F. X. McGohey, *Judge,* granting plaintiff's motion for summary judgment and denying defendant's motion for summary judgment. Reversed.

FRANK A. FRITZ, New York, N. Y. (Bleakley, Platt, Gilchrist & Walker; Horace N. Taylor, Bouvier Beale, Cyril Crimmins, and Frank A. Fritz, Jr., New York, N. Y., on the brief), *for plaintiff-appellee.*

MORTON S. ROBSON, Assistant U. S. Attorney, Southern District of New York, New York, N. Y. (Paul W. Williams, U. S. Attorney, S. D. N. Y., on the brief), *for defendant-appellant.*

HINCKS, *Circuit Judge*:

A Collector of Internal Revenue appeals from a summary judgment in favor of the plaintiff taxpayer in its action to recover that part of a surtax on "undistributed section 102 net income" which had allegedly been erroneously assessed under §102 of the 1939 Code,* and thereafter collected.

The facts are not in dispute. In 1945 the taxpayer, whose accounts throughout had been kept on cash receipts and disbursement basis, incurred federal income tax liabilities of $142,660.64 and paid this sum in 1946. Its income tax liability for 1946 was $726,036.46 and this was paid in 1947 except for $24,396.00 which was paid in 1949. In 1949 the Commissioner assessed and collected a §102 surtax against the taxpayer for the year 1946 in the amount of $565,070.70 plus interest. In computing the amount of the plaintiff's undistributed section 102 net income for 1946, the Commissioner took the plaintiff's section 102 net income, as defined in §102(d)(1), to be its net income for 1946 minus its 1945 taxes (which had been paid in 1946).

The plaintiff concedes that it was liable for a Section 102 surtax. But it contends that § 102(d)(1), defining "section 102 net income" as "net income * * * minus [f]ederal income * * * taxes * * * paid or accrued during the taxable year," required the subtraction of taxes *accrued* during

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* In this opinion all references to the "Code" are to the Code of 1939 unless otherwise specified and the references to Section 102 are to Section 102 of the 1939 Code.

1946, and that since these taxes exceeded the 1945 taxes deducted by the Commissioner, it is entitled to a refund in the amount by which the § 102 surtax for 1946 would have been reduced if the Commissioner had subtracted the plaintiff's 1946 income tax accrued rather than the 1945 income tax paid. On cross motions for summary judgment, Judge McGohey, in an opinion reported at 115 F. Supp. 310, granted the plaintiff's motion and awarded it $266,061.41 plus interest. The only question presented on this appeal is whether in the determination of the section 102 net income for 1946 the Commissioner should have subtracted from 1946 net income the 1946 income tax accrued but not paid in 1946, instead of the 1945 income tax which was paid in 1946.

The statutory objective of § 102 of the Code is, as Judge McGohey stated and as the parties concede, to force improper accumulations of each year's income out of the "incorporated pocketbook" of business corporations and into the hands of stockholders where they will be taxable, by the imposition of a penalty tax on the amounts accumulated.

Section 102 is in Chapter 1 of the Code, which also includes § 48. The latter section provides: "When used in this chapter * * * [t]he terms 'paid or incurred' and 'paid or accrued' shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part." The Commissioner's action in this case was plainly in accord with the letter of this provision: the plaintiff's accounts were kept on a cash basis and the Commissioner subtracted the income taxes *paid* in 1946. The plaintiff urges that "paid or accrued" in § 102 should have the meaning attributed to the phrase when used in the personal holding company sections of Chapter 2 of the Code. 26 U. S. C. A. 500 *et seq.* (1939). It points to the cases holding that, for purposes of the personal holding company surtax, even a cash basis taxpayer may

deduct income taxes accrued, but not paid, in the taxable year. *Joan Carol Corporation* v. *Commissioner*, 2 Cir., 180 F. 2d 751; *Aramo-Stiftung* v. *Commissioner*, 2 Cir., 172 F. 2d 896; *Commissioner* v. *Clarion Oil Co.*, D. C. Cir., 148 F. 2d 671, cert. den. 325 U. S. 881. It argues that the Congressional history shows an intent that the same principles apply to personal holding companies and to corporations subjected to § 102 surtax, and that the legislative objective does not contemplate that a corporation, when subjected to the § 102 surtax, shall be penalized by a drastic surtax on moneys held to pay a tax already accrued which must be paid in the following year,—a result which seems especially unfair in cases in which the liability for accrued taxes is large in comparison with the amount of earnings retained in excess of legitimate business requirements.

If the decisional law were now in the state existing when the case was submitted to Judge McGohey we well might have affirmed on his lucid opinion below. However, in the intervening time the Supreme Court has announced its decisions in *United States* v. *Olympic Radio & Television*, 349 U. S. 232 and *Lewyt Corp.* v. *Commissioner*, 349 U. S. 237, holding that under § 122 of the 1939 Code, a taxpayer on an accrual basis could not, in computing its net operating loss for one year, deduct the amount of excess profits taxes which were paid in that year but which had accrued in an earlier year. In those cases, as here, the controversy concerned an interpretation of the term "paid or accrued." In the *Olympic Radio* case, the court was concerned with the phrase as it appeared in § 122, which is a part of Chapter 1 of the Code: here we are concerned with the phrase as it is used in § 102 of the Code which is also a part of Chapter 1. In *Olympic Radio* the Supreme Court said:

> "Section 41 states the general rule that net income shall be computed 'in accordance with the method of accounting regularly employed in keeping the books' of the taxpayer.

"Section 43 provides that deductions and credits may be taken 'for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a definite period.'

"Section 48 provides, 'When used in this chapter * * * (c) The terms * * * "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.' This provision of § 48 would itself seem to be conclusive of the question, since § 122 is 'in this chapter,' to use the language of § 48. And § 48, together with § 41 and § 43, seem to indicate that the words 'paid or accrued' have only one meaning throughout the chapter, not the changeable meaning which the taxpayer seeks to give them.

"We deal here with a deduction which one obtains not as of right, but as of grace. *Dempsey* v. *du Pont*, 308 U. S. 488, 493. The taxpayer has the burden to show that it is within the provision allowing the deduction. But the effort here made, if successful, would cause 'paid or accrued,' as used in § 122(d)(6), to mean something different than it does in other sections of the same chapter; and that would fly in the face of the express command of § 48."

The Court accordingly rejected the taxpayer's contention that it had "an option to take deductions on a basis that is inconsistent with the method of accounting that it employs." And it made the same holding in the *Lewyt* case. Under the constraint of these cases, we must reject the plaintiff's contentions in the case now before us.

It is true, as plaintiff points out, that the *Olympic Radio* and the *Lewyt* cases had to do with computation of a deduc-

tion from *net income* computed for purposes of the carry-back provisions of § 122, and did not directly involve the problem here, viz., the computation of "section 102 net income," which is defined as "the net income * * * *minus* [f]ederal * * * taxes * * * paid or accrued during the taxable year." However, the rationale of *Olympic Radio* and the language from its opinion as quoted above require us to give the same meaning to "paid or accrued" throughout Chapter 1. The attempted distinction, therefore, does not remove the instant case from the scope of the *Olympic Radio* holding. And the plaintiff's assertion that in the case here there is absent a *need for uniformity* in the interpretation of "paid or accrued," even were it true, is irrelevant. For Congress by § 48 has commanded a uniform interpretation of the phrase as it appears throughout Chapter 1.

The plaintiff points to the exceptive clause in § 43 of the Code, which allows deductions to be taken "as of a different period" from that on the basis which "the net income is computed." But this exceptive clause is wholly irrelevant for present purposes. By its express terms it is applicable only when necessary "to clearly reflect the income," which in the context of the section means the "net income,"—not the "section 102 net income." We find in the exceptive clause of § 43 no sanction for the proposition that a taxpayer, in order to reduce its liability for a section 102 surtax, may be accorded an option to change its customary accounting basis as to one or more of its liabilities whenever such a change will result to its advantage. Cf. *United States* v. *Mitchell*, 271 U. S. 9; *Security Mills Co.* v. *Commissioner*, 321 U. S. 281.

The taxpayer claims that unlike the carry-back povision of § 122 in *Olympic Radio* and *Lewyt Corp., supra*, this case concerns a "penalty" tax, and § 102 should be *liberally construed* in favor of the taxpayer. We agree

that the Section 102 surtax is a penalty tax. Nevertheless it lay within the power of Congress to determine the amount and the incidence of the penalty. Sections 102 and 48 when read together in the light of *Olympic Radio* leave no room for the *liberal construction* for which the plaintiff contends. When a cash basis taxpayer is once found to be subject to a section 102 surtax the amount thereof is computed upon the "undistributed section 102 net income" (§ 102(a)), which includes so much thereof as will be needed in a later year for the payment of all liabilities accrued, but not paid, in the taxable year. 49 Yale L. J. 171, 180.

If the result seems unduly harsh on a cash basis taxpayer, such as the plaintiff, the effect is due to the tax payer's election to account on a cash basis. And of course the surtax would never have attached if the plaintiff had not subjected itself to a Section 102 surtax in contravention of the taxing policy. If, even so, the result is unduly harsh it was for Congress to make the change. *United States* v. *Olympic Radio, supra.* The provisions of the Code of 1954, Sections 531 *et seq.*, which touch this subject-matter are applicable only to taxable years beginning after December 31, 1953. See Section 7851(a) of the Code of 1954.

Reversed.

Appendix C

Statutes and Regulations

Section 102. Surtax on Corporations Improperly Accumulating Surplus.

(a) Imposition of tax.

There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in Section 501 or a foreign personal holding company defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.

(b) *Prima facie* evidence.

The fact that any corporation is a mere holding or investment company shall be *prima facie* evidence of a purpose to avoid surtax on shareholders.

(c) Evidence determinative of purpose.

The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid

surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary.

(d) Definitions.

As used in this chapter—

(1) Section 102 net income.

The term "section 102 net income" means the net income, computed without the benefit of the capital loss carry-over provided in section 117(e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23(s), minus the sum of—

(A) Taxes.

Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1940) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

* * * *

(2) Undistributed section 102 net income.

The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27(b), but the computation of such credit under section 27(b)(1) shall be made without its reduction by the amount of the credit provided in section 26(a), relating to interest on certain obligations of the United States and Government corporations.

(Internal Revenue Code of 1939, 53 Stat. 35, as amended 53 Stat. 868 (1939); 55 Stat. 693, 700 (1941); 56 Stat. 807, 835, 836 (1942); 59 Stat. 570 (1945).)

Section 43. Period for which Deductions and Credits Taken.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. • • •

(Internal Revenue Code of 1939, 53 Stat. 24, as amended 56 Stat. 830 (1942).)

Section 48. Definitions.

When used in this chapter • • •

(c) "Paid or incurred", "paid or accrued".

The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

(Internal Revenue Code of 1939, 53 Stat. 26, as amended 56 Stat. 835 (1942).)

Section 500. Surtax on Personal Holding Companies.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal

holding company (in addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

(Internal Revenue Code of 1939, 53 Stat. 104, as amended 54 Stat. 521 (1940); 55 Stat. 695 (1941); 56 Stat. 894 (1942).)

Section 504. Undistributed Subchapter A Net Income.

For purposes of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) minus—

* * * *

(b) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; * * *

(Internal Revenue Code of 1939, 53 Stat. 107, as amended 55 Stat. 44 (1941); 56 Stat. 829, 895, 896 (1942).)

Section 505. Subchapter A Net Income.

For the purposes of this subchapter the term "Subchapter A Net Income" means the net income with the following adjustments:

(a) Additional deductions. There shall be allowed as deductions—(1) Federal income, war profits, and excess profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section

500, or a section of a prior income-tax law corresponding to either of such sections. * * *

(Internal Revenue Code of 1939, 53 Stat. 108, as amended 53 Stat. 869 (1939); 56 Stat. 835, 846 (1942).)

Section 507. Meaning of Terms Used.

"(a) General Rule. The terms used in this section shall have the same meaning as when used in chapter 1."

(Internal Revenue Code of 1939, 53 Stat. 111.)

Regulation 118, § 39.505-1(f)—With respect to the additional deduction allowed in section 505(a)(1), relating to Federal income, war-profits, and excess profits taxes paid or accrued during the taxable year, a cash basis taxpayer may deduct either the taxes paid or the taxes accrued during the taxable year. However, a taxpayer which in any taxable year deducts the taxes accrued during such year shall in each subsequent taxable year deduct the taxes accrued during such subsequent year.

Appendix D

Excerpts from Briefs Filed by the Government in the Supreme Court in *Olympic* and *Lewyt* Cases

A. Excerpts from Government's brief in Olympic case:

From pages 5-6:

> Taxpayer is not aided by *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C.A. D.C.), and similar cases involving the imposition of a penalty surtax on the undistributed income of personal holding companies. Those cases hold that while the statutory definitions of "paid or accrued" in terms control the method of computing net income (see 148 F. 2d at 675), they need not be applied in determining the penalty tax on undistributed income prescribed by subchapter A of chapter 2. The net operating loss deduction claimed in the instant case relates solely to the "computing [of] net income" (Section 23(s)) and, under the reasoning of *Clarion Oil*, the statutory definition of "paid or accrued" controls.

From pages 16-17:

> The line of cases upon which the majority below relied (R. 13) is clearly distinguishable.[8] Those cases involved provisions of the Code imposing a penalty surtax on the undistributed profits of personal holding companies. In computing the amount of undistributed

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[8] *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C.A. D.C.), certiorari denied, 325 U. S. 881; *Aramo-Stiftung* v. *Commissioner*, 172 F. 2d 896 (C. A. 2d); *Birmingham* v. *Loetscher Co.*, 188 F. 2d 78 (C. A. 8th); *Wm. J. Lemp Brewing Co.* v. *Commissioner*, 18 T. C. 586, 600-601, acquiesced in by the Commissioner, 1952-2 Cum. Bull. 2. The recent decision in *Harry M. Stevens, Inc.* v. *Johnson*, 115 F. Supp. 310 (S.D. N.Y.), pending on appeal (C. A. 2d), involving surtax under Section 102 on corporations improperly accumulating surplus, is distinguishable on like grounds.

profits, Section 505(a) permitted, *inter alia*, the deduction of excess profits taxes "paid or accrued during the taxable year." The cases in question hold that for the purposes of these penalty provisions, which are incorporated in the personal holding company surtax provisions of Sections 500 *et seq.*, Chapter 2, the definitions of "paid or accrued" contained in Chapter 1 (see Sections 43 and 48(c), discussed *supra*, pp. 12-13) need not be deemed controlling. Thus, speaking of Section 48(c), the court stated in the *Clarion Oil* case (148 F. 2d, p. 675):

> But, obviously, this definition was intended to apply to the method of computing *net income*, and has no reference or relevancy to the subject matter of what, for the purposes of the newly added provision in relation to personal holding companies, is taxable as *undistributed* income.

B. Excerpts from Government's brief in Lewyt case:

From pages 8-9:

> The line of cases exemplified by *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C.A.D.C.), certiorari denied, 325 U. S. 881, was properly distinguished below. Those cases involved the penalty tax on undistributed income of personal holding companies and rest on the rationale that a company is not to be penalized "for not distributing as dividends money which it either does not have, because it pays it out in back taxes during the year, or which prudence would require it to keep, because it will be needed to pay taxes accrued during the year though not payable until the following year . . ." (dissenting opinion of Judge Madden in the *Olympic* case, No. 10, R. 14). Indeed, the *Clarion Oil* decision itself emphasized (148

F. 2d at 676) that, in computing the penalty tax on undistributed income, "[t]here is absent the administrative need for uniformity which exists for the computation of net income." The determination of a net operating loss deduction is, of course, an integral part of the computation of net income. If one factor in calculation of loss is computed on the cash basis and other calculations of profit and loss are computed on the accrual basis, the necessary effect is to distort net income. Even without an explicit statutory definition, one would hardly ascribe to Congress the purpose of authorizing a single taxpayer to adopt internally inconsistent methods of computing profit and loss factors. Section 48(c) in terms forbids that practice.

From pages 19-22:

2. Taxpayer places considerable reliance upon the line of cases exemplified by *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C.A.D.C.), certiorari denied, 325 U. S. 881.[10] However, these cases, which involve the penalty surtax on undistributed income of personal holding companies, were properly distinguished in both courts below (R. 33, 68-69) and in the Government's brief in No. 10 (pp. 16-17). The distinction is summarized in Judge Madden's dissenting opinion in the *Olympic* case (No. 10, R. 14), as follows:

> To penalize a corporation for not distributing as dividends money which it either does not have, because it pays it out in back taxes during the year, or which prudence would require it to keep, be-

[10] See, also, *Aramo-Stiftung* v. *Commissioner*, 172 F. 2d 896 (C. A. 2d); *Birmingham* v. *Loetscher Co.*, 188 F. 2d 78 (C. A. 8th); *Harry M. Stevens, Inc.* v. *Johnson*, 115 F. Supp. 310 (S.D. N.Y.), pending on appeal, C. A. 2d.

> cause it will be needed to pay taxes accrued during the year though not payable until the following year, would seem to amount to penalizing sound management. The instant situation presents no comparable pressure of equity against the text of the statutes.

It should also be noted that in the *Clarion Oil* decision itself the court pointed out (148 F. 2d at 676) that in computing the penalty tax on undistributed income, "[t]here is absent the administrative need for uniformity which exists for the computation of *net* income." The determination of a net operating loss deduction is, of course, an integral part of the computation of net income. To permit one factor in calculation of loss to be computed on the cash basis, while all other calculations of profit and loss entering into a determination of net income are computed on the accrual basis, necessarily distorts net income. The precise function of Sections 43 and 48(c) is to avoid such a result."

Taxpayer also asserts that the court below misapprehended the *Clarion Oil* line of cases. It states (Br. 21) that the court below—

> plainly in error . . . overlooked Section 307(a) of the Code . . . which states that

[11] The scheme of the Code with respect to taxation of undistributed income of foreign personal holding companies (Sections 331-340) does not support taxpayer's argument as to the meaning of the *Clarion Oil* cases (Br., pp. 26-27). In computation of the undistributed income of these companies there is also absent the administrative need for uniformity which exists for the computation of net income. That the tax is imposed not upon the company but upon its "United States shareholders" in the guise of a constructive dividend seems quite irrelevant. Section 337. There is, of course, no correlation between accounting systems or income computation of a corporation and a stockholder.

Excerpts from Briefs filed by the Government in the Supreme Court in Olympic and Lewyt Cases.

"The terms used in this subchapter [subchapter A of Chapter 2, the statute involved in *Clarion Oil*] shall have the same meaning as when used in Chapter 1."

This is rested upon the following sentence in the Court of Appeals' opinion (R. 68): "*Stated otherwise*, Chapter 2 contains no provisions comparable to § 48(c) and § 43 of Chapter 1 defining the phrase 'paid or accrued.'" (Emphasis added.)

A reading of the two preceding sentences (not quoted by taxpayer) shows, however, that the court was not oblivious of Section 507(a), and that it correctly interpreted the *Clarion Oil* case as holding that the Chapter 1 definition of "paid or accrued" was not meaningful for purposes of determining when a personal holding company had undistributed income. These two sentences read as follows (R. 68):

The ground of these decisions, as exemplified by *Clarion*, is that the provisions of § 48(c) in Chapter 1 of the Internal Revenue Code defining "paid or accrued" in terms of a taxpayer's method of reporting for the purpose of computing *net income* under that Chapter, have no application to the meaning of § 505(a)(1) permitting deduction of excess profits taxes for the purpose of computing the *undistributed income* tax on personal holding companies under Chapter 2. "But, obviously, this definition [48(c)] was intended to apply to the method of computing *net income*, and has no reference or relevancy to the subject matter of what, for the purposes of the newly added provision in relation to personal holding companies is taxable as *undistributed* income." *Clarion*, at p. 675.

Appendix E

Judgment on Mandate

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

Civ. 70-138

HARRY M. STEVENS, INC.,

Plaintiff,

v.

JAMES W. JOHNSON, Former Collector of Internal Revenue, Third District, New York,

Defendant.

The above-named defendant having appealed to the United States Court of Appeals for the Second Circuit from an order and judgment, entered in the office of the Clerk of the United States District Court for the Southern District of New York, filed November 18, 1953, granting the motion of the plaintiff for summary judgment as to Count 2 of the complaint, and the said appeal having come on to be heard before the United States Court of Appeals for the Second Circuit, and the said Court having rendered its decision reversing the order and judgment of the District Court and having issued its mandate, dated November 9, 1956,

Now, on motion of Paul W. Williams, United States Attorney for the Southern District of New York, it is

ORDERED, ADJUDGED and DECREED that the mandate of the United States Court of Appeals for the Second Circuit

be and it is hereby made the order and judgment of this Court; and it is

FURTHER ORDERED, ADJUDGED and DECREED, that the order and judgment of the District Court heretofore entered on the 18th day of November, 1953, be and the same hereby is vacated and set aside in so far as it grants judgment to the plaintiff as to Count 2 of the complaint; and it is

FURTHER ORDERED, ADJUDGED and DECREED that the defendant James W. Johnson have judgment against the plaintiff Harry M. Stevens, Inc., dismissing the complaint herein, together with costs, as taxed in the Court of Appeals in the sum of $116.65, and costs in this Court as taxed amounting to $20.00 making a total of $136.65, and that the defendant have execution therefor.

Dated: New York, December 17th, 1956.

EDMUND L. PALMIERI,
U.S.D.J.

HAC

EDMUND L. PALMIERI,
U.S.D.J.

Judgment Entered: 12/17/56

HERBERT A. CHARLSON
Clerk

JB

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In the Supreme Court of the United States

OCTOBER TERM, 1956

No. 737

HARRY M STEVENS, INC., PETITIONER

v.

JAMES W. JOHNSON, FORMER COLLECTOR OF INTERNAL REVENUE FOR THE THIRD DISTRICT OF NEW YORK

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (Pet. 15–19) is reported at 115 F. Supp. 310. The opinion of the Court of Appeals (Pet. 20–26) is reported at 238 F. 2d 436.

JURISDICTION

The judgment of the Court of Appeals was entered on November 9, 1956 (R. 49a). The petition for a writ of certiorari was filed February 1, 1957. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Whether a cash basis taxpayer, in computing its undistributed net income for 1946 for purposes of the surtax imposed thereon by Section 102 of the Internal Revenue Code of 1939, may deduct the amount of federal income tax liability incurred for the year 1946 (but paid in 1947) or may deduct only the amount paid in 1946 (for income tax liability incurred in 1945).

STATUTE INVOLVED

The pertinent provisions of Sections 41, 43, 48 (c), 102 (a) and (d), 500, 504 (b), 505 (a), and 507 (a) of the Internal Revenue Code of 1939 are set forth in the Appendix, *infra*, pp. 10–14.

STATEMENT

The facts, which are not in dispute, may be summarized as follows:

Harry M. Stevens, Inc. (hereinafter called taxpayer), whose accounts during the period in question had been kept on the basis of cash receipts and disbursements, incurred federal income tax liabilities of $142,660.64 in 1945 and paid this sum in 1946. Taxpayer's income tax liability for 1946 was $726,036.46, and this was paid in 1947 (except for $24,396 which was paid in 1949). (Pet. 21.)

In 1949, the Commissioner assessed and collected a surtax against taxpayer for the year 1946 in the amount of $565,070.70 plus interest based upon the provisions of Section 102 of the Internal Revenue Code of 1939. In computing the amount of the surtax, the Commissioner took the taxpayer's "section

102 net income," as defined by Section 102 (d) (1) of the Code, to be its net income for 1946 minus its 1945 taxes, which had been paid in 1946. (Pet. 21.)

Taxpayer filed a suit for refund, contending that the statute defining "section 102 net income" entitled it to deduct the amount of taxes accrued during 1946, and that, since this amount exceeded the 1945 taxes deducted by the Commissioner, it is entitled to a refund in the amount by which the Section 102 surtax for 1946 would have been reduced if the Commissioner had subtracted taxpayer's 1946 income tax accrued rather than the 1945 income tax paid (Pet. 21–22).

On cross-motions for summary judgment, the District Court granted the taxpayer's motion and awarded it $266,061.41 plus interest (Pet. 22). On review, the Court of Appeals unanimously reversed (Pet. 20–26).

ARGUMENT

Section 102 (a) of the Internal Revenue Code of 1939 (Appendix, *infra*, p. 11) imposes a surtax upon the net income of a corporation which is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting earnings or profits to accumulate instead of being divided or distributed. This surtax is equal to the sum of specified percentages of the amount of what is termed the "undistributed section 102 net income," which is defined as "section 102 net income" minus certain credits. See Section 102 (d) (2) (Appendix, *infra*, pp. 11–12). "Section 102 Net Income" is defined, insofar as material here,

as "the net income * * * minus * * * Federal income * * * taxes *paid or accrued* during the taxable year * * *" (emphasis added). See Section 102 (d) (1) (Appendix, *infra*, pp. 11–12).

Taxpayer concedes that it is liable for the surtax imposed by Section 102, but contests the Commissioner's computation of the amount thereof. The taxpayer's contention is that, even though it is on the cash basis, the statute allows it, in arriving at the amount of "section 102 net income," to deduct the amount of federal income taxes *accrued* during the year in question, rather than the amount *paid* in that year. (Pet. 21–22.) As the court below held, however, it is clear from the language of Sections 41, 43, and 48 (c) of the 1939 Code (Appendix, *infra*, pp. 10–11), and from this Court's interpretation of those provisions in *United States* v. *Olympic Radio & Television*, 349 U. S. 232, and *Lewyt Corp* v. *Commissioner*, 349 U. S. 237, that a cash basis taxpayer may only deduct the amount of federal income taxes *paid* in the year in question in determining its "section 102 net income."

1. As in the *Olympic* and *Lewyt* cases, the controversy here revolves around the meaning of the phrase "paid or accrued" as used in Chapter 1 of the 1939 Code. Section 48 (c) provides that "paid or accrued," when used in Chapter 1, "shall be construed according to the method of accounting upon the basis of which the net income is computed." In *Olympic* and *Lewyt*, this Court held that Section 48 (c) (together with related Sections 41 and 43) governed the

meaning of "paid or accrued" wherever the phrase is used in Chapter 1 of the Code. Applying that holding to the facts of those cases, this Court further held that an accrual basis taxpayer could not, in computing his net operating loss for one year under Section 122 (d) (6), deduct the amount of excess profit taxes which were paid in that year but which had accrued in an earlier year. Conversely, in the instant case, it follows that a cash basis taxpayer, in computing his federal income tax liability under Section 102 (d) (1) (A), also within Chapter 1, may only deduct the amount of taxes paid in the year for which the deduction is sought. See *Helvering* v. *Price*, 309 U. S. 409, 413; *United States* v. *Mitchell*, 271 U. S. 9. The applicable statute and decisional law are conclusive of the issue in this case, and there is no need to grant certiorari in order to "set the matter straight," as taxpayer asserts. (Pet. 13.)

2. Insofar as taxpayer's arguments are based upon alleged equitable considerations (Pet. 11–12), it is clear that such considerations do not control the question of what deductions are permissible. *United States* v. *Olympic Radio and Television*, *supra*, p. 236.[1] The tax benefit being sought by taxpayer in the instant case in the form of the subtraction of its federal in-

[1] It does not appear that the taxpayer can properly point to the existence of any inequities. As the Court of Appeals noted (Pet. 26): "If the result seems unduly harsh on a cash basis taxpayer, such as the plaintiff, the effect is due to the taxpayer's election to account on a cash basis. And of course the surtax would never have attached if the plaintiff had not subjected itself to a Section 102 surtax in contravention of the taxing policy."

some tax liability from its net income in order to lessen its Section 102 surtax is no less a deduction than that sought in the *Olympic* case and should not be accorded any different consideration. And, as the court below stated (Pet. 26): "If * * * the result is unduly harsh it was for Congress to make the change. *United States* v. *Olympic Radio*, *supra*."[1]

3. There is no conflict of decisions. The cases which taxpayer asserts are in conflict (Pet. 9) involve the interpretation and application of the phrase "paid or accrued" as used in the provision relating to the deduction of federal taxes in computing the surtax on personal holding companies.[2] See Section 505 (a) (1) of the 1939 Code (Appendix, *infra*, p. 13). That the scheme of taxation in the personal holding company sections differs from that presented by the sections here in question is apparent from the face of the statute.[3] In any event, irrespective of the correctness of these decisions construing Section 505 (a) (1), the provision involved here—Section

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[1] As noted below, p. 8, Congress did change the statutory provisions in the 1954 Code so that now only federal income taxes *accrued* may be deducted for purposes of computing the amount of the surtax. Section 535 (b) (1), Internal Revenue Code of 1954.

[2] *Commissioner* v. *Clarion Oil Co.*, 148 F. 2d 671 (C. A. D. C.), certiorari denied, 325 U. S. 881; *Birmingham* v. *Lostocher Co.*, 198 F. 2d 78 (C. A. 8th). See also *De Soto Securities Co.* v. *Commissioner*, 235 F. 2d 409 (C. A. 7th), and T. D. 6079, 1954-2 Cum. Bull. 276.

[3] Among the differences is the fact that the reasonableness of the accumulation is immaterial in the former provisions, while it is of the essence in Section 102. Section 102 is not operative if the accumulation is reasonable in view of the needs of the business,

102 (d) (1) (A)—is within Chapter 1, and, for the reasons already stated, is plainly governed by Section 48 (c) as construed in the *Olympic* and *Lowy* cases. It may also be noted that two decisions of the court below[1] which are in accord with the alleged conflicting decision, construing the personal holding company tax, were obviously not regarded by it as a bar to its decision in the Government's favor here.

4. There likewise is no merit in taxpayer's assertion that (Pet. 8), "If the Court of Appeals decision were to stand, it would allow the Government to benefit

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and, as a consequence, the deductions authorized by the statute have no relation to the reasonable needs of the business. On the other hand, the personal holding company provisions operate irrespective of any consideration of the needs of the business; even though the retained income is absolutely necessary for the conduct of the business of the personal holding company, it would still be subject to tax, unless one of the specified deductions was applicable. By contrast, as the court below observed (Pet. 26), "When a cash basis taxpayer is once found to be subject to a section 102 surtax the amount thereof is computed upon the 'undistributed section 102 net income' (§ 102 (a)), which includes so much thereof as will be needed in a later year for the payment of all liabilities accrued, but not paid, in the taxable year."

It is also to be noted that Congress, in the 1954 Code, has made different provision for the deduction of federal taxes of personal holding companies and of corporations improperly accumulating surplus. In the former case (Section 545 (b) (1), Internal Revenue Code of 1954), a taxpayer which formerly deducted federal income taxes when paid may irrevocably elect to deduct the taxes paid or accrued, while in the latter (Section 555 (b) (1), Internal Revenue Code of 1954) there is no such election and all taxpayers subject to the surtax must deduct the taxes accrued.

[1] *Aroma-Stiftung* v. *Commissioner*, 172 F. 2d 896 (C. A. 2d); *Joan Carol Corp.* v. *Commissioner*, 180 F. 2d 751 (C. A. 2d).

from the Government's unsupportable repudiation of the express representations which the Government made to this Court in the *Olympic* and *Lowgt* cases." In reply, it is sufficient to say that this Court, in deciding the *Olympic* and *Lowgt* cases, found it unnecessary to consider the distinctions made in the lower court opinions and Government briefs in those cases (Pet. 32-39), but instead decided the cases on broader grounds. In the instant case, the court below and the Government had no alternative but to recognize *Olympic* and *Lowgt* as binding in interpreting the statutory provisions here in issue.

5. The question decided by the court below has now been settled by legislation and hence possesses no general importance for the future. In the 1954 Code, Congress changed the provisions with respect to deductibility of federal income taxes in computing the counterpart of "section 102 net income" under the 1939 Code. Sections 531, 532, and 535 (a) and (b) (1), Internal Revenue Code of 1954 (26 U. S. C. 1952 ed., Supp. II, Secs. 531, 532, and 535 (a) and (b) (1)). The 1954 Code now allows in the case of all taxpayers, cash or accrual, "as a deduction Federal income * * * taxes * * * *accrued* during the taxable year * * *" (emphasis added). Section 535 (b) (1), *supra*. This provision is applicable to all taxable years beginning after December 31, 1953. Section 7851 (a) (26 U. S. C. 1952 ed., Supp. II, Sec. 7851 (a)).

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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MARCH 1957.

APPENDIX

Internal Revenue Code of 1939:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

* * * * *

(26 U. S. C. 1952 ed., Sec. 41.)

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred," dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

(26 U. S. C. 1952 ed., Sec. 43.)

SEC. 48. DEFINITIONS.
When used in this chapter—

* * * * *

(c) *"Paid or Incurred," "Paid or Accrued."*—The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under this Part.

* * * * *

(26 U. S. C., 1952 ed., Sec. 48.)

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) [As amended by Sec. 103 (d) of the Revenue Act of 1941, c. 412, 55 Stat. 697] *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

"27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

"38½ per centum of the undistributed section 102 net income in excess of $100,000."

* * * * *

(d) [As amended by Sec. 202 (b) of the Revenue Act of 1941, *supra*, and Sec. 138 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

(1) *Section 102 Net Income.*—The term "section 102 net income" means the net income computed without the benefit of the capital loss carry-over provided in section 117 (e) from a taxable year which begins after December 31, 1940, and computed without the net operating loss deduction provided in section 23 (s), minus the sum of—

(A) *Taxes.*—Federal income, war-profits, and excess-profits taxes (other than the tax imposed by Subchapter E of Chapter 2 for a taxable year beginning after December 31, 1939) paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

* * * * *

(2) *Undistributed Section 102 Net Income.*—The term "undistributed section 102 net income" means the section 102 net income minus the basic surtax credit provided in section 27 (b), but the computation of such credit under section 27 (b) (1) shall be made without its reduction by the amount of the credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(26 U. S. C. 1952 ed., Sec. 102.)

SEC. 500 [As amended by Sec. 110(a) of the Revenue Act of 1941, *supra*, and Section 181 of the Revenue Act of 1942, *supra*]. SURTAX ON PERSONAL HOLDING COMPANIES.

There shall be levied, collected, and paid, for each taxable year beginning after December 31, 1938, upon the undistributed subchapter A net income of every personal holding company (in

addition to the taxes imposed by chapter 1) a surtax equal to the sum of the following:

(1) 75 per centum of the amount thereof not in excess of $2,000; plus

(2) 85 per centum of the amount thereof in excess of $2,000.

(26 U. S. C., 1952 ed., Sec. 500.)

SEC. 5011. UNDISTRIBUTED SUBCHAPTER A NET INCOME.

For the purposes of this subchapter the term "undistributed subchapter A net income" means the subchapter A net income (as defined in section 505) minus—

* * * * *

(b) Amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

* * * * * *

(26 U. S. C., 1952 ed., Sec. 504.)

SEC. 5035. SUBCHAPTER A NET INCOME.

For the purposes of this subchapter the term "Subchapter A Net Income" means the net income with the following adjustments:

(a) *Additional Deductions.*—There shall be allowed as deductions—

(1) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction under section 23; but not including the tax imposed by section 102, section 500, or a section of a prior income-tax law corresponding to either of such sections.

* * * * * *

(26 U. S. C. 1952 ed., Sec. 505.)

SEC. 5097 [As amended by Sec. 227 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862]. MEANING OF TERMS USED.

(a) *General Rule.*—The terms used in this subchapter shall have the same meaning as when used in chapter 1.

* * * * *

(26 U. S. C. 1952 ed., Sec. 507.)